

12 December 2014

Via email

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Dear Mr Roberts

JGN 2015-20 access arrangement draft decision – capex and cross-period pass through

We are keen to ensure Jemena Gas Networks' (JGN) revised access arrangement (AA) proposal is targeted at matters of substance and also provides sufficient evidence for the AER to consider our revised proposal. To assist us in meeting these objectives, I am writing to seek clarity on certain statements made, and conclusions drawn, in the AER's draft decision for JGN.

For timeliness and manageability, this letter relates to:

- capex (related party margin, connection unit rates, government authority work and total planning costs)
- cross-period pass through.

We may seek further clarification on other areas of the draft decision in the coming weeks.

Please note we claim confidentiality over the contractor payment and margin dollar values included in this letter (including attachments 1 and 2).

Related party margins—submitted information potentially overlooked

The draft decision states that:

JGN proposed [c-i-c] of related party margin expenditure associated with connections. We do not consider that JGN justified this expenditure in its proposal. JGN did not set out why a Zinfra margin is incurred or how the margin

is calculated. We therefore have not included it in our alternative estimate of capex.¹

We seek clarification on this issue as our proposal did set out why a Zinfra margin is incurred and how the margin is calculated—refer to the material extracted from our proposal in **attachment 1**. We also explained the basis for the margin at our meeting with your team on 22 November 2013—the relevant presentation slides are provided in **attachment 2**.

Furthermore, in our response to clause 9 of the AA RIN and clauses 9.4 and 9.5 in particular, we described JGN's outsourcing arrangements including the Field Services Agreement (**FSA**) between JAM and ZNX(2), under which the management fee and management margin are paid. That response included a significant volume of supporting documentation including a copy of the FSA and its associated annexures.

In JGN's view, the information we have provided, taken together, should have been sufficient to enable the AER to conclude in its draft decision that the FSA arrangements, including the management fee and management margin, are in fact efficient.

As such, we seek clarification whether this information was taken into account in the AER's draft decision on related party margins.

Market expansion unit rates—current contract rates overlooked

The unit rates adopted in the draft decision for market expansion are JGN's historical unit rates for mains, services and meters for the 5 years 2008-09 to 2012-13 as reported in our response to the AA RIN, discounted by an assumed amount for direct overheads (page 6-10). As a consequence of this choice, the AER has also implicitly disallowed the Zinfra management fee which was included in the forecast unit rates in our RIN response. We explained the need for the management fee payment in appendix 4.1 of the AAI.

We note that the draft decision also explicitly disallows the Zinfra management margin (page 6-26—see above) which was embedded (together with the Zinfra management fee) in the unit rates that JGN has used in the Forecast Capex Model to build its forecast of market expansion capex.

JGN queries the approach taken by the AER in determining these unit rates for its draft decision. Those average historical unit rates clearly do not reflect current contract unit rates which the draft decision endorses as market-tested and efficient (page 6-47). It is unreasonable to expect that JGN can obtain the relevant services for the historical rates which were fixed from 2008-09 to 2010-11 and only caught up with the growth in market indices in 2012-13 following the Northern Region tender process which resulted in new contracts for these services, commencing 1 July 2013.²

We are hoping to arrange a meeting with the AER to discuss this matter prior to Christmas.

Government authority work (GAW)—misunderstood basis of forecast

¹ AER, JGN 2015-20 draft decision, Attachment 6 capital expenditure (confidential), 6-26.

² JGN, Appendix 4.1, JGN's pipeline service delivery model, pages 1 and 24

The draft decision deals with GAW on pages 6-40 and 6-41.

In our presentation to AER staff on 14 March 2014, we stated that gross GAW is of the order of \$7.5M per year, so that our forecast of [c-i-c] for the regulatory period (\$2013 unescalated and excluding overheads) was a net amount:

- GAW costs JGN around \$7.5M per annum, of which around \$7M is recovered from the requesting party
- JGN therefore includes an allocation of [c-i-c] per annum for minor capital to reflect unrecoverable work (refer **attachment 3**).

That is, JGN's forecast of [c-i-c] per annum (\$2013 unescalated and excluding overheads) is a net amount after contributions. As we explained in our presentation on 14 March 2014, JGN does not have the right to recover asset relocation costs in some circumstances.

We acknowledge that the AAI and forecast capex report (AAI appendix 6.7) did not make this point explicitly. This may have led to a misunderstanding and hence the draft decision that forecast GAW should be offset by customer contributions. We seek clarification whether the AER continues to hold to that position in light of this clarification, or whether you require further information from us to substantiate our GAW forecast.

Total planning costs—draft decision unclear

On pages 6-46 and 6-47 of the draft decision the AER states that it:

- considers planning costs to be an overhead cost, and
- does not accept JGN's forecast *step change* in planning costs (italics added).

The AER does not state what alternative forecast it has adopted. Moreover, we cannot identify any amount for planning costs in the AER's overhead calculation. We request clarification of the amount of forecast total planning costs that the AER has approved in its draft decision, and where this amount has been (or should be) reflected in the draft decision models.

Cross-period pass through—AER engagement not considered

The draft decision states:

We do not approve JGN's proposed fixed principle in relation to cost pass through events from an immediately prior access arrangement. This fixed principle is proposed to relate to clause 3.5 of the access arrangement.

Rule 99 of the NGR states that a full access arrangement may include a principle declared in the access arrangement to be fixed for a stated period.

We recognise that there may be a lag of at least 12 months between JGN's final opportunity to vary Reference tariffs under a particular access arrangement and the commencement of a new access arrangement. However, JGN did not provide reasons for including this fixed principle in the access

*arrangement. Accordingly, we are not satisfied that the inclusion of this fixed principle in its access arrangement is consistent with the NGO.*³

Cross-period pass through is required for matters including to:

- give effect to the return of residual cost savings from the repeal of the Clean Energy Act on 17 July 2014, estimated at approximately \$700,000
- enable the tariff variation mechanism to move to t-2 adjustments—required to allow us to bring forward our annual tariff variation notices to 15 March each year, providing more time for AER assessment and retailers to incorporate our prices.

JGN has:

- provided a description of the move to t-2 adjustments⁴ and the change to the tariff variation process⁵ in its AAI
- engaged with the AER on the need for cross period pass through via a staff meeting on 12 September 2013 (refer **attachment 4**) and sought clarification on the AER's position⁶
- received a letter from the AER, acknowledging the merits of cross-period pass through with the following advice:

I note the implications of the absence of a mechanism to address cross period pass through are not insignificant. The insertion of a fixed principle into JGN's access arrangement to allow for cross period pass throughs would be consistent with the treatment of these events under the amendments made to the National Electricity Rules in August 2012 and APA GasNet's access arrangement.

*JGN should include the proposed provision in its revised access arrangement fixed principles for AER's consideration as part of the review.*⁷

- engaged regularly with the AER on the approach to return cost savings to customers as a result of the Clean Energy Act.⁸

We seek clarification whether this information was taken into account in the AER's draft decision on cross-period pass through.

We would be happy to meet with the AER to discuss these matters if this would be useful, prior to receiving your written response. Also, please feel free to contact me on (03) 8544 9053 or at robert.mcmillan@jemen.com.au or Alex McPherson on (02) 9455 1504 or at alex.mcperson@jemen.com.au if you would like to discuss these issues further.

³ AER, *JGN 2015-20 draft decision, Attachment 11 – reference tariff variation mechanism*), 11-22.

⁴ JGN, *2015-2020 Access Arrangement Information*, p.129.

⁵ JGN, *2015-2020 Access Arrangement Information*, p.130.

⁶ JGN, Letter to Sebastian Roberts from Shaun Reardon, *JGN Access arrangement – cross period pass through*, 2 December 2013.

⁷ AER, Letter to Shaun Reardon from Sebastian Roberts, *JGN Access arrangement – cross period pass through*, 16 January 2014.

⁸ This culminated in AER staff confirming its preferred process via email from Craig Madden on 24 October 2014.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. McMillan', with a long horizontal flourish extending to the right.

Robert McMillan
General Manager Regulation
Jemena Limited

Attachment 1 – Extracts from JGN 2015-20 AA proposal

Appendix 4.1, pages 12-13

JAM recovers from JGN the costs of Zinfra's services under the AMA on a cost pass through basis. Payments made by JAM to Zinfra under the FSA are:

- unit-rate-based charges for construction work, and repair and maintenance services carried out by Zinfra staff or third-party subcontractors [c-i-c]
[c-i-c]
[c-i-c]

...

The FSA Management Fee and Management Margin have been structured:

- to cover Zinfra's comprehensive quality system that underpins subcontractor compliance management
- [c-i-c]

JGN obtained comfort on the overall level of the FSA Management Fee and Management Margin by:

- benchmarking Zinfra total costs against the estimate of JAM's internal costs to self-manage the work program and subcontractor compliance. The total of the FSA Management Fee and Management Margin outperforms JAM internal costs on the following key benchmarks:

[c-i-c]

- benchmarking Zinfra profit margin against 2007-2011 range from NERA Benchmark Study of Contractor Profit Margins, which the AER relied upon in its Murraylink determination. JGN has since obtained an updated benchmark study from K Lowe Consulting, which also shows the Zinfra profit margin to be well within the reasonable range (see appendix 6.8 of the 2015-20 AAI).

- obtaining an independent probity review by E&P⁹ on the FSA Management Fee (excluding the Management Margin¹⁰), which concluded that:
 - the methodology and approach used to calculate the on-costs was reasonable
 - the management fee benchmarking approach was reasonable
 - it is reasonably anticipated and acceptable that the management fee as a percentage of the overall works is marginally below the Jemena reference costs for the Northern Region due to the increased volume of work in the Southern Region.

⁹ E&P, *JGN – Review of Pricing Methodology Report*, June 2013, p.17. (JGN provided the E&P report as appendix 4.2 to the 2015-20 AAI).

¹⁰ E&P excluded the Zinfra margin from its analysis on the basis that there was no direct comparable with the Jemena structure in the Northern Region.



FSA—Southern region arrangements (1)

- Field Services Agreement with Zinfra for Southern Region— negotiated at arm’s length
- Two types of payments to Zinfra:

[c-i-c]

Commercial-in-confidence

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FSA—Southern region arrangements (3)

- Zinfra management fee:
 - Includes cost of a comprehensive Zinfra quality system that underpins subcontractor compliance management
 - Zinfra costs benchmarked against Jemena’s estimate of internal costs to self-manage the work program and subcontractor compliance
 - Zinfra profit margin benchmarked against 2007-2011 range from NERA Benchmark Study of Contractor Profit Margins that the AER relied upon in its Murraylink determination
- [c-i-c]
- Jemena’s assessment of Zinfra management fee reviewed by independent probity advisor, concluding:
 - a reasonable methodology had been used for the calculation of on-costs,
 - management fee benchmarking approach was reasonable, and
 - management fee benchmarking outcomes were reasonable and acceptable

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Jemena

Background

- Government authority and private landowners can request JGN to move its assets
- Legacy agreements will differ in whether JGN is able to gain recovery (often based on the upfront costs incurred to gain access).
- This costs JGN around \$7.5 per annum, of which \$7M is recovered from the requesting party.

[c-i-c]

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Attachment 4 – Extract from presentation given by Jemena staff to AER staff on 12 September 13 at AER offices



Cross period pass through – current period to 2015 period

- JGN is considering how best to manage risks if a cost pass through event occurs after the AER approves JGN's 2014 tariff variation, resulting in one or more of the following scenarios:
 - expenditure incurred after 2014 tariff variation but before end of current AA period
 - expenditure not incurred until new AA period, even though event occurred in current AA period
 - expenditure incurred either side of 1 July 2015

- Some of the potential issues:
 - two tariff variations in regulatory year 2014/15 would be sub-optimal, even though current AA permits this
 - query how current AA responds where event occurs before 1 July 2015, but expenditure incurred post 1 July 2015
 - due to the nature and timing of the event, may not be possible to forecast post-1 July 2015 expenditure from this event when draft AA proposal goes in

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Example

Administrative true-up process

Year of variation	2011	2012	2013	2014	Currently no true up for
Licence Fee Event	No adjustment	2010-11 year refund to customers	2011-12 year refund to customers	2012-13 year value TBC	2013-14 and 2014-15
UAG adjustment event	2010-11 year refund to customers	2011-12 year refund to customers	2012-13 year pass through to customers	2013-14 year value TBC	2014-2015

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Cross period pass through – 2015 period to 2020 period

- The AER approved a fixed principle to give effect to cross period pass through in APA Gasnet's 2013-17 AA
 - APA GasNet's previous AA also had similar provisions
- The fixed principle allows the financial impact of an event in the earlier period to be included in the following period where
 - the financial impact was not included in tariffs for the earlier period
 - the timing did not permit the pass through to be included in the earlier period
- Jemena is considering proposing a fixed principle (similar to APA Gasnet) to give cross period certainty for future AA periods